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Southesk

ENERGY LTD

ANNUAL REPORT 1996

AR60

President's Message

TO THE SHAREHOLDERS

This report marks the conclusion of two years of operations for Southesk Energy Ltd. as an oil and gas fund. We are pleased to report continued success, although not to the degree which we hoped to achieve.

Oil prices have been exceptionally strong, increasing steadily month-by-month since the beginning of the 1996 fiscal year. Some of that strength can be attributed to the perception of demand exceeding supply as major fields come into a decline phase, even though some of the OPEC countries continue to produce in excess of their monthly quotas. More recently, the Iraqi/Kuwait political situation has brought added tension to oil supplies from the Middle East, bringing oil prices to an unprecedented (and unsustainable) high. While those higher prices remain in force, the Canadian oil industry can enjoy significantly higher levels of revenue, cash flow, and net earnings. Natural gas prices are receding from high levels during the cold winter, but all companies are receiving better value for that product this year compared to last. However, there continues to be a surplus of natural gas and inadequate transportation facilities to move more of the product to market,

particularly in the northeastern USA. No significant improvement in gas transmission facilities is expected for another 1-2 years at the earliest. The fund holdings are predominantly on the oil, rather than the natural gas side, so our portfolio benefits from this strong oil market.

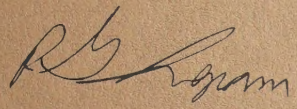
Throughout most of the past year the company's investments had a market value in excess of cost. As at June 30, 1996 market value of our investments was $122,316 below cost. Since year end the value of the company's investments has risen dramatically and at August 31, 1996 had a market value of $100,000 above cost.

In the two months since year end Southesk has sold investments and realized gains of $30,000. If the oil market remains strong, and we believe that it will, the company could show a substantial profit for the year ending June 30, 1997. This is very positive news, however, because the company is a public company all profits are taxed at close to 50%. To avoid paying tax the Board of Directors have agreed unanimously to invest up to 10% of the fund in oil and gas exploration or development "plays".

The idea of investing 10% of the fund directly to exploration or development has been discussed at length over the past year and was approved by the Board for two reasons. The first reason being corporate tax. Exploration expenditures can be 100% expensed for tax purposes. In other words, $150,000 spent on an exploratory well can reduce taxable income by $150,000 in the year the funds were spent or it can be carried forward to be applied against taxable income in future years. The second reason is that we have built a close relationship with the top management of the companies we have substantial investments in and Southesk has been approached by some of these companies to participate in their next drilling project. Frank McEachern along with the Board will analyze very closely any proposed drilling investment before proceeding.

Southesk will remain an oil and gas fund with Frank McEachern as our advisor. We, as shareholders of Southesk, are very fortunate to have Frank as our advisor, as our investments have out performed the TSE oil and gas index since the company's inception two years ago. Frank will address the shareholders at the annual meeting to be held in Edmonton at the Petroleum Club on Friday, November 15, 1996 at 4:00 p.m.

Respectfully submitted,



R.G. Ingram, C.A.
President

This Year in Review

AN INTRODUCTION

FRANK D. McEACHERN
is an independent oil & gas analyst based in Calgary, Alberta. He is the author of the monthly McEachern Oil Letter and serves as the advisor to Southesk Energy Ltd.

In the 1995 report, we referred to the merger/acquisition activity in the oil industry and that the trend would likely continue well into 1996. It did, and is expected to carry on into next year. Our oil and gas fund had three holdings in the portfolio which were acquired by other companies: (i) Vista International Petroleum Ltd. purchased in August 1995 for $2.20 per share by a private company (our cost $1.29); (ii) Strike Energy Inc. acquired by Tarragon Oil and Gas Limited in a share exchange

(our shares of SEN were sold in the open market, rather than exchanged); and (iii) Petrostar Petroleums Inc. purchased by Crestar Energy Inc. for shares (our PPE holdings were exchanged for the appropriate number of CRS shares, later sold in the open market). All were profitable purchases/sales for our fund. Having three oil and gas investments disappear via the acquisition route in just one twelve month period is unusual. Several of our current fund holdings are candidates for acquisition by other companies, and indeed at the time of writing, one particular situation is being closely analyzed by potential buyers.

Apart from one early setback in our investment portfolio, and occasional minor monthly corrections, the fund has appreciated in value steadily since inception. At fiscal year end, four of our ten individual stocks were below purchase price; more recently, all but two of eleven are well ahead of our costs. We look forward to reporting to you next year with even better news.

The Canadian oil industry operates in a continual state of flux, or change. Even companies with little apparent stock market appeal sometimes do very well, perhaps from **exploratory successes, or from the acquisition of another company, or even from a change in senior management. All of these events have occurred in our industry during the past year. In other cases, promises and projections made by management do not come to pass, and the shares fall to even lower price levels. Perception (of success or failure) plays a significant role in the market place.**

We continue to seek out attractive investment situations, and have increased the portfolio value by another 15%, subsequent to the fiscal year end. The components of the portfolio at June 30, 1996 are reviewed briefly on the following pages.

I look forward to seeing you again at the annual meeting of the shareholders.

The Year in Review cont...

CRESTAR ENERGY INC.
(CRS - TSE)

Shares in this company came to us from the takeover of Petrostar Petroleums Inc. via the exchange of one CRS share for each 14.8 PPE shares. Our resultant holding of Crestar was too small to justify keeping and was sold in the open market. It was a profitable transaction.

DRAIG RESOURCES LTD.
(DRG - ASE)

This is a very small holding acquired at a cost of just over $0.27 per share, below what I believe is a reasonable Net Asset Value of $0.45 - $0.60 (depending upon the Discounted Rate used on future Cash Flow). Imminent drilling on an oil-play in central Alberta, if successful, would mean a coincident increase in oil production and could readily move the share price up by 50% or more. Currently, oil revenues contribute 40% to the total, gas sales another 54%, with the remaining 6% from gas plant processing fees. Success at Chigwell (referred to above) could boost the oil revenue component to 50%, reduce the gas sales contribution to 47%, and the gas processing share to 3%.

FOSSIL OIL & GAS LIMITED
(FOL - TSE)

Shares in this company have been part of the portfolio since 1995; the shares have until recently, traded below our acquisition price of $2.80. The company is now the subject of a potential takeover and the market price has reacted accordingly. We noted in the previous annual report that "...this value will eventually be recognized in the market place,..." It now looks as if that more realistic appreciation of the company is about to come true. The Company is debt free at the moment; corporate revenue comes from oil (70%), natural gas (28%), and other (2%). The Net Asset Value of Fossil shares is in the range of $3.25 - $3.50, depending upon the Discounted Rate of future Cash Flow selected for the calculation.

HURRICANE HYDROCARBONS LTD.

(HHL.A - ASE/TSE)

Shares of this company were first purchased in December 1995 at a price of $1.69 per share. We have since doubled our holding for a unit cost of $3.29, substantially below recent stock market trading. For many years, this company has been attempting to develop some very large oil fields in Kazakstan. Delays of one kind or another have set Hurricane back until now. In May, the Company announced its submission of a bid for Yuzhneftegaz, owned by the Government of Kazakstan, and a 25% partner with HHL.A in some of its projects. The assets of Yuzhneftegaz are reported to include current oil production of 50,000 barrels per day and reserves exceeding 500 million barrels of oil. The company recently reported its success in winning the bid for those properties, and at the time of writing this report, is close to receiving some of the oil revenue and cash flow from the properties. There continues to be risk in this investment - as there is in almost all stocks - but we believe the rewards (measured in capital appreciation) outweigh those risks. The Company recently completed an equity financing for a major portion of the purchase price of the Yuzhneftega's oil assets.

OILTEC RESOURCES LTD.

(OIL - TSE)

Oiltec Resources Ltd. was incorporated in January 1992 as a private company, formed initially to act as general partner for several Limited Partnerships. By mid-1993, those holdings together with other oil and gas assets were purchased by Oiltec for 3.5 million shares, valued at $1.00 per share. Additional acquisitions followed, and have continued almost to today, with the result that this junior-sized oil company has become a highly regarded component of the oil industry. The Company has been at the forefront of several industry "firsts" concerning submersible pumps, drilling fluids, sucker rods (for oil-well pumping), and coiled tubing, all instrumental in the drilling and/or subsequent production from horizontal wells. Activities are spread from northwestern Alberta to southeastern Saskatchewan, with about 90% of corporate revenue from oil sales, and the remaining 10% from natural gas. Our 150,000 share investment was purchased at an average cost of $1.06 per share, and at this stage is considered a longer-term hold for even more capital appreciation. The Net Asset Value is calculated to be in the range of $1.30 per share, but should be higher soon as more drilling successes are developed.

The Year in Review cont...

PALLISER ENERGY INC.
(PSR.A - ASE)

During February 1996 a 300,000 share block of Palliser Energy Inc. was purchased at a cost of $0.66 per share, trading at the time of writing at just under $1.00. This company began several years ago as a Junior Capital Pool (JCP). Very little was accomplished until 1993 but more recently the company has developed a significant oil asset in the Viking Kinsella area, east of Edmonton.
The potential for growth of PSR.A has scarcely been touched, given the degree of success thus far in that area. Company working interests range from 22% to 100%.
In addition to the conventional oil and gas activity, the company owns 100% of Petro Well Servicing, a well-service organization with eleven service rigs, enjoying a high level of activity so far this year. Service rigs are always in demand - regular and frequent well work-overs are normal to maintain and even improve well productivity.
Approximately one-half of PSR.A's annual cash flow can be attributed to the well-service component.

RAIDER RESOURCES LTD.
(RDR - ASE)

The Southesk purchase of 1.135 million shares of RDR was at a cost of $0.15 per share. The initial entry into this investment occurred in July 1995, followed one month later by purchasing a large share block.
The share performance to date has been neutral, due in large part to delays encountered in (i) reorganizing the company, and (ii) concluding both property acquisitions and asset disposals. The company in its original format was incorporated in June 1987 and had a dismal history prior to 1995 when a new shareholder acquired control.
At a recent Special Meeting of Shareholders, approval was given to consolidate the shares on the basis of one New for each eight Old, and to approve the acquisition of a natural gas property from Imperial Oil Resources for approximately eight million dollars. For the first six months of the current fiscal year, RDR's revenue was split approximately 50-50 between oil and gas. The area of focus for RDR is the Calgary-Edmonton corridor where multizone oil and gas reservoirs are present, thus reducing the exploration risk and providing more opportunities to develop oil, gas, and natural gas liquids reserves.
We view this investment positively and expect to show significant profit within the next year or two.

SAXON PETROLEUM INC.
(SXN - ASE/TSE)

Shares of this company continue to trade very poorly; it is not our intention to retain this holding indefinitely. As noted in last year's report, the association with Enron Gas Marketing Canada, Inc. came to a close, to be replaced by voting control being acquired by Forest Oil Corporation, head quartered in Denver, Colorado. Over 90 million common shares are now issued and outstanding: a major change in revenue and cash flow is required to be noticeable on a per-share basis. Recently the Company was able to discharge all bank debt via the sale of $15-million preferred shares. The Company has announced the discovery of what could become a large oil/gas pool west of Edmonton, although at this time, firm details are not available.

WESTWARD ENERGY LTD.
(WEL.A - TSE)

Although this investment is currently one of our less attractive holdings in terms of profits, we have lowered our unit costs to $1.64 from an earlier $1.87 per share via additional purchases. Exploratory successes have been far fewer in recent months than experienced years ago, and we now have to wait through the process of corporate rebuilding, hopefully from oil and/or gas discoveries in the company's focus area of southern Alberta. A recent oil discovery in the Enchant area may be the beginning of a new growth period for Westward. Although no details are as yet available, that well, drilled on 52.5% working interest acreage, is of sufficient promise that several more locations are now defined as potential oil wells. Westward now has 14,000 acres under control in this area and hopes to develop the project over the next 1-2 years. All company revenue comes from the production and sale of crude oil. Depending upon the rate of discounting used for the future cash flow streams, the Net Asset Value of Westward Energy Ltd. shares is variously computed to range between $1.50 and $1.90 per share. We believe this investment will work out satisfactorily.

ZARGON OIL & GAS LTD.
(ZAR - TSE)

Investing in this company was one of the early purchases of Southesk Energy Ltd. and over time, we have added to our holdings, bringing the number of shares held in the fund to 128,500 at a cost of $1.35 per share. Although this company is still not well known in the oil and gas industry, it continues to have strong support from individuals both in Canada and the USA, and one or two institutional accounts headquartered in Ontario. Activity is directed in part to central Alberta, but more significantly to southeastern Saskatchewan, which has become a "hot" area of exploration and development drilling activity. Approximately 85% of ZAR's revenue comes from oil production, the remaining 15% from natural gas. The Net Asset Value of Zargon shares is estimated to range between $2.70 (at a Discounted Cash Flow rate of 10%) to $2.15 (at 15%). We believe the capital appreciation potential has not yet been reached.

Auditor's Report

TO THE SHAREHOLDERS

We have audited the balance sheet of Southesk Energy Ltd. as at June 30, 1996, and the statements of earnings and retained earnings and changes in financial position for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at June 30, 1996, and the results of its operations and changes in its financial position for the year then ended in accordance with generally accepted accounting principles.

Chartered Accountants
August 9, 1996

D. Lotte & Touche.

	1996	1995
ASSETS		
CURRENT		
Cash and term deposit	$63,674	$450,935
INVESTMENTS (Note 3)	1,577,386	1,148,618
	$1,641,060	$1,599,553
LIABILITIES		
CURRENT		
Accounts payable	$2,000	$2,000
Income taxes payable	4,217	3,568
	6,217	5,568
SHAREHOLDERS' EQUITY		
Share capital (Note 4)	1,567,382	1,560,632
Retained earnings	67,461	33,353
	1,634,843	1,593,985
	$1,641,060	$1,599,553

APPROVED BY THE BOARD

Director

Director

	1996	1995
REVENUE		
Gain on sale of investments	$91,913	$50,322
Interest income	6,162	21,242
	98,075	71,564
EXPENSES		
Advisory fees	24,404	16,902
Office and Administrative	18,110	4,941
Rent	12,840	10,700
Professional fees	4,396	2,100
	59,750	34,643
EARNINGS BEFORE INCOME TAXES	38,325	36,921
INCOME TAXES (Note 5)	4,217	3,568
NET EARNINGS	34,108	33,353
RETAINED EARNINGS, BEGINNING OF YEAR	33,353	–
RETAINED EARNINGS, END OF YEAR	$67,461	$33,353
EARNINGS PER SHARE		
Basic and fully-diluted	$0.035	$0.035

	1996	1995
Net Inflow (Outflow) of Cash Related to the Following Activities		
OPERATING		
Net earnings	$34,108	$33,353
Item not affecting cash		
Gain on sale of investment	(91,913)	(50,322)
	(57,805)	(16,969)
Changes in non-cash operating working capital items		
Accounts payable	–	2,000
Income taxes payable	649	3,568
	(57,156)	(11,401)
INVESTING		
Purchase of investments	(1,294,028)	(1,514,799)
Proceeds on disposal of investments	957,173	416,503
	(336,855)	(1,098,296)
FINANCING		
Share issue costs	–	(144,368)
Issuance of share capital	6,750	1,650,000
	6,750	1,505,632
Net Cash (Outflow) Inflow	(387,261)	395,935
Cash & Term Deposits, Beginning of Year	450,935	55,000
Cash & Term Deposits, End of Year	$63,674	$450,935

1. NATURE OF BUSINESS

The Company was incorporated under the provisions of the Business Corporations Act (Alberta) on March 8, 1993. The Company holds investments in oil and gas companies and commenced operations on July 1, 1994.

2. ACCOUNTING POLICY

These financial statements have been prepared in accordance with generally accepted accounting principles and include the following significant accounting policy:

Investments

Investments are recorded at cost. When it becomes apparent that a permanent decline in the value of an investment has occurred, the investment is written down to reflect such a decline.

3. INVESTMENTS

	1996			1995	
	Number of Shares	Cost	Market	Number of Shares	Cost
Fossil Oil & Gas Ltd.	85,000	$237,698	$199,750	50,000	$154,163
Westward Energy Ltd.	121,300	225,319	121,300	–	–
Zargon Oil & Gas Ltd.	158,500	214,038	296,395	44,300	57,611
Palliser Energy Inc.	300,000	197,925	216,000	–	–
Raider Resources Ltd.	1,135,500	169,082	124,905	–	–
Saxon Petroleum Inc.	290,000	162,883	98,600	300,000	168,500
Oiltec Resources Ltd.	150,000	158,947	168,000	–	–
Crestar Energy Inc.*	5,891	131,603	140,795	119,600	194,211
Hurricane Hydrocarbons Ltd.	24,300	59,301	66,825	–	–
Draig Resources Ltd.	75,000	20,590	22,500	–	–
Vista International Petroleum Ltd.	–	–	–	130,050	167,194
Harbour Petroleum Company Ltd.	–	–	–	40,000	159,705
Strike Energy Inc.	–	–	–	52,400	125,459
Cimarron Petroleum Ltd.	–	–	–	10,000	121,775
	2,345,491	$1,577,386	$1,455,070	746,350	$1,148,618

*Previously Petrostar Petroleums Inc.

4. SHARE CAPITAL

Authorized

unlimited number of voting common shares

	1996	1995
Issued		
965,500 common shares (1995 - 962,500 common shares)	$1,567,382	$1,560,632

In 1995, the Company issued through a public offering 750,000 units consisting of one common share and one warrant which entitles the holder to purchase one common share of the Company at an exercise price of $2.25 on or before March 1, 1996. During the year, the expiry date was extended to August 19, 1996 and 3,000 warrants were exercised in exchange for 3,000 common shares for cash of $6,750.

Of the 965,500 issued voting common shares, 70,200 shares are held in escrow pursuant to a policy of the Alberta Securities Commission and may not be released from escrow without the consent of the Chief of Securities Administration.

5. INCOME TAXES

The Company's effective tax rate approximates 44%. The provision for income taxes does not reflect this rate as the Company is allowed to deduct a portion of share issue costs in determining its taxable income over a five year period.

6. RELATED PARTY TRANSACTIONS

A Director of the Company is also a partner in a legal firm which provided legal services to the Company in the amount of $2,120 during the year (1995 - $11,449).

7. COMMITMENT

The Company has entered into an Advisory Agreement for investment advisory services for the year ending June 30, 1997. Under the terms of the agreement, the Adviser will be paid, on a monthly basis, one-twelfth of 1-1/2% of the total market value of the Company's investment portfolio.

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